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MEMORANDUM FOR CABINET OFFICERS AND AGENCY HEADS

FROM: Joseph R. Wright Jr.
Deputy Director, OMB and Chairman, Federal
Credit Policy Working Group, EPC

SUBJECT: Prepayment Guidelines

Attached is a copy of the prepayment guidelines for the FY 1988 loan asset sale pilot program. These prepayment guidelines have been incorporated into the revised loan asset sale guidelines recently sent to you.

In 1987, five agencies conducted prepayment programs. Gross proceeds of $2.5 billion from prepayments accounted for a large portion of the total revenue generated by the entire FY 1987 loan asset sale pilot program. Last year the prepayment option was offered before the successful third party sale of Rural Development Insurance Fund loans, and College Facilities loans. In each instance the prepayment program was an important element of the overall loan asset sale strategy. Additionally, prepayments assist privatization while avoiding some of the costs associated with third party sales such as underwriter fees, and printing costs.

In FY 1988, prepayments will continue to be a big part of the pilot program. Therefore, the guidelines have been revised to define more clearly the technical requirements of the prepayment program.

These guidelines should ensure that agencies enlist the services of a financial advisor. A financial advisor will help an agency to conduct an asset valuation of its portfolio and assist the agency to determine an acceptable prepayment price by providing pricing options in accordance with A-70.

Once again, thank you for the eagerness and enthusiasm you and your staffs exhibited for the FY 1987 sales. I trust these prepayment guidelines will be of assistance.

Attachment

REGISTRY
60-7

ZA-5

LOAN ASSET SALES AND PREPAYMENT GUIDELINES

February 16, 1988

I. Introduction

The following guidelines for the sale of loan assets and prepayments have been established and approved by the Federal Credit Policy Working Group. The guidelines are designed to insure that agencies will meet the objectives of the loan asset sale program which have been derived from the Administration's stated priority to reform Federal credit. These objectives are set forth as follows:

- reduce the Government's cost of administering credit by transferring servicing, collection, and other administrative activities to the private sector;
- provide an incentive for agencies to improve loan origination and documentation;
- determine the actual subsidy of a Federal credit program; and
- increase unified budget offsetting collections in the year of sale.

II. Guidelines for Loan Asset Sales

The following guidelines shall be adhered to by each agency in its approach to, and implementation of, all loan asset sales. However, the Federal Credit Policy Working Group realizes that there are or will be occasions for which changes to the guidelines will be necessary. Agencies are encouraged to bring problems to the Working Group for discussion. The guidelines have been amended to reflect modifications already authorized by the Working Group, and will be modified periodically in the future to reflect additional changes.

A. Loan asset sales shall be made without future recourse to the Federal Government. For the purposes of these guidelines, recourse includes any Federal guarantee of principal or interest payments; agreements to repurchase loans or to replace delinquent loans with current loans; warranties as to collateral value; and other agreements entailing continued Federal involvement that could create contingent liability. Recourse does not include: representation and warranty obligations in accordance with Guideline B; changes in internal agency policy or regulations needed to satisfy the agency's legal obligations to borrowers; arrangements made by the purchaser of the loans to provide for credit enhancement measures (such as overcollateralization, reserve funds or insurance) that do not impose contingent liability on the agency or the government; or retention by the Federal Government of a junior security representing a residual interest in the income produced by the loans after the sale. Agencies planning to retain a junior interest for more than 18 months or for an indefinite period must submit to OMB a plan for disposition.

B. If necessary, agencies may include in a loan sale agreement representations and warranties to the purchaser of loan assets concerning matters of fact and law, such as the characteristics of loans, the agency's authority to sell loans, and the legal enforceability of loans and security interests. Agencies may not warrant as to the future credit-worthiness of borrowers. The duration of warranty periods will be based on reasonable time periods for verification and will be determined on a case-by-case basis. The remedy for a breach of warranty may include substitution of an alternative loan not initially included in the sale pool or cash payment by an agency up to the value of the defective loan. Each agency is responsible for ensuring that it has the resources needed to satisfy warranty obligations. Loan sale agreements incorporating warranties shall be signed by an agency official of appropriate rank and shall name the individual agency as the warrantor. The text of warranties should be reviewed by OMB and Treasury.

C. Loans of tax-exempt entities shall be sold only if the future interest payments on the loans are subject to full Federal income tax. This does not preclude sales of securities representing pooled loans or whole loans to tax-exempt investors for portfolio or trading accounts in the normal course of business, but is meant to preclude purchases by such investors from the proceeds of tax-exempt borrowings made for that purpose. Further, the financing of prepayments of loans shall be on a taxable basis; that is, borrowers should not issue tax-exempt bonds to prepay their outstanding loan balances.

D. Agencies should seek to contract out the servicing of loan assets prior to sale. If for valid reasons agencies are not able to do so before sale, collection and servicing shall be transferred to the purchaser with the sale of a loan asset.

E. Agencies shall sell loans and prepare to sell loans in the amounts stated in the budget for FY 1988 and FY 1989. Agencies shall sell newly issued loans and seasoned loans from their portfolios after approval of their sale plan.

F. Where appropriate, each agency shall choose, through a competitive process, professional financial consultant to provide expertise on its loan asset sale program. Consultants will not be permitted to purchase loans from programs on which they are advising.

G. Loan asset sales may be conducted on a competitive bid or negotiated basis. In the latter case, the invitation to negotiate should be disseminated widely, and negotiations conducted as competitively as possible.

H. In limited circumstances where the borrower is not an individual, agencies may offer current borrowers the right to purchase their loans if that seems likely to achieve the highest price; borrowers who are not current on their principal and interest payments shall not be allowed to purchase their loans.

I. Loan asset sales shall be sufficiently large to assure market interest. This is particularly important when developing markets for new types of securitized loans. In such cases, we would expect sales to be over $100 million. Other details, including timing of sales, the composition and size of loan pools, and other marketing issues, shall be handled individually by each agency and will vary from portfolio to portfolio depending on market conditions.

J. Agencies may sell loan assets held by the FFB.

K. Agencies should not sell loan assets directly to Government-Sponsored Enterprises or to entities acting on their behalf for their own account.

L. To the extent possible, newly made loans should be sold on a regular basis within six months of when the loan was closed. It is recommended that when newly made loans are scheduled for sale, agencies arrange for private servicing from the beginning. All proceeds from the sale of newly made loans will flow into the Treasury General Fund, absent legislation to the contrary.

made loans are scheduled for sale, agencies arrange for private servicing from the beginning. All proceeds from the sale of newly made loans will flow into the Treasury General Fund, absent legislation to the contrary.

M. In competitive bid situations agencies should be prepared to analyze bids for minimum price acceptability against an established valuation methodology. It is not likely that there will be good reason to disclose the methodology or price floors to bidders. Any such minimum price valuation methodology should be reviewed by OMB and Treasury.

III. Guidelines for Prepayment at a Discount 1/

A. In limited cases (where the borrower is not an individual and not delinquent on loan payments), agencies may offer current borrowers the right to purchase their loans if that seems likely to achieve the highest price. Borrowers may become eligible to purchase their loans only if all past due principal, interest and charges are paid in full prior to discounting the remaining balance.

B. Proceeds from the prepayment of loan assets, net of the agency's reasonable and approved costs of sale, shall be deposited into the Treasury General Fund.

C. The financing of prepayments of loans shall be on a taxable basis; that is the borrowers may not prepay their outstanding loan balances either directly or indirectly through tax-exempt borrowings.

D. The prepayment plan and proposed price must be set very carefully to avoid undue cost to the Government or additional subsidy to the borrower. In general, the price should be calculated by discounting the remaining payments due on the loans by a composite interest rate consisting of the current market yield on Treasury securities of comparable maturities plus an allowance for administrative expenses and possible losses.

1/ Except for REA because of FY 1989 proposed budget reforms.

E. A financial advisor should be engaged to perform the following tasks and summarize the results in a report to the agency:

- o Conduct a portfolio valuation;
- o Compare pricing options; and
- o Provide a fairness letter.

Based on the financial advisor's report, the agency should develop a prepayment program and schedule. The plan must include an analysis of the pricing option offered. Prepayment plans and proposed pricing should be submitted to OMB and Treasury for review prior to any offering.